

reserve calculation for the transfer may be using a reserve distribution that existed one and one-half years before. It was also noted that the reserve ratio table used to calculate the net book for transfer is on an interstate reserve basis, rather than on an intrastate depreciation reserve basis.

Recommendation

No errors were noted in the data reviewed, but the auditors recommend that the process for calculating the depreciation reserve and net book values be mechanized to prevent errors, reduce labor expense and expedite journal processing. Since the Company indicates that such a mechanized system is scheduled to be implemented by February 1995, no further action is required in this area.

14. Recent legislative and regulatory initiatives increase the urgency of eliminating subsidies found in this audit.
-

Summary

In its 1994 session the Georgia State Legislature considered, but did not adopt, legislation (Senate Bill 566) which would have significantly changed the regulatory framework for Southern Bell.⁵⁴ The legislation would have eliminated monitoring or regulation of Southern Bell's rate base and rate of return. In lieu of such regulation, the rates for all services would be deemed just and reasonable at the date the Company files its notice of intent to adopt alternative regulation. S.B. 566 would have provided the Company the unrestricted ability to set the prices for its enhanced, competitive and new services. At the same time it would be assured of indexed price increases from its monopoly POTS service. There would be no further surveillance reporting or any other type of earnings scrutiny.⁵⁵

If there is an imminent likelihood that the existing rates will be deemed just and reasonable, then the Commission must accelerate its efforts to ensure that there are no unreasonable subsidies embedded in these rates. This finding notes the consequent urgency to implement action to resolve the issues raised

⁵⁴In June 1994 the Company filed a similar proposal entitled Georgians FIRST, with the Commission. Georgians FIRST apparently contains certain slight modifications to Senate Bill 566. The auditors will focus on Senate Bill 566 for the purposes of this finding since it was the first effort.

⁵⁵S.B. 566, section 46-5-165(c).

in numerous other findings regarding cross-subsidies and cost shifts.

Criteria

Telecommunications companies in Georgia may not use current revenues earned or expenses incurred in conjunction with services subject to regulation to subsidize services which are not regulated or tarified.⁵⁶ One of the objectives of this audit was to learn whether Southern Bell's customers are protected from cross-subsidy. The Commission has defined cross-subsidy as any action undertaken by SBT which results in an understatement of intrastate regulated revenues or an overstatement of intrastate regulated expenses or investment for SBT.⁵⁷

Condition

In early 1994 SB proposed and lobbied for legislation titled "The Telecommunications Competition, Consumer Protection, and Economic Development Act of 1994" (S.B. 566). Although the legislation was ultimately withdrawn, it reflects the Company's goals and intentions. S.B. 566 would have accepted all existing service rates as just and reasonable. Services would have been divided into three categories: basic local exchange service, interconnection or access services, and "all other" services.

"Basic local exchange service is the flat rated, voice service

⁵⁶O.C.G.A. Section 46-2-23(g).

⁵⁷Docket No. 3987-U.

within a local calling area (plain old telephone service -- "POTS") provided to residents and single line [businesses]."⁵⁸ Prices for basic local exchange service would be capped at their current level for three years and then allowed to increase by the cumulative change in inflation. Increases within the inflation limit would not be reviewable by the Commission. Government mandated changes such as separations changes would be automatically flowed into basic local exchange service rates.

Intrastate interconnection or access service rates would be set at a maximum defined by the interstate rate level and capped.

The prices for "all other services" would be set by the Company. Although there was a provision to require toll service rates to include the incremental cost of toll plus the foregone contribution from access, toll rates could have been set at even lower prices.

S.B. 566 would have eliminated rate base rate of return regulation and removed the Company's depreciation rates from the jurisdiction of the Commission.

The Company stressed to the auditors that S.B 566 was not a "deregulation bill" rather it was a "price regulation proposal".

The following quotations are taken directly from S.B. 566:

"Deregulate" means to remove a service from the jurisdiction of and oversight or regulation by the Georgia Public Service Commission or the provisions of this article. [46-5-162(5)].

⁵⁸Summary of "The Telecommunications Competition, Consumer Protection, and Economic Development Act of 1994", SB, February 4, 1994, p. 4.

"New service" means a function, feature, capability or combination of such which has not previously been offered. [46-5-162(13)].

The earnings of the telecommunications company eliciting alternative regulation under this article shall not be subject to rate of return or rate base monitoring or regulation. [46-5-165(c)].

Any telecommunications company electing alternative regulation under this article shall not be required to seek regulatory approval of its depreciation rates or schedules. [46-5-165(d)].

The telecommunications company electing alternative regulation under this article may determine its rates, terms, and conditions for telecommunications services not defined as basic local exchange services and interconnection services. Such services may be provided by the telecommunications company through tariff, contract, or commercially reasonable means. The rates, terms, and conditions may include flexible pricing options, including but not limited to deaveraged variable rates and volume discounts. [46-5-169].

Any service not regulated by the commission as of the date of the filing of the notice of the intent to elect the alternative regulation described in this article shall continue to be unregulated and not subject to the jurisdiction of the commission. [46-5-170(a)].

A telecommunications company may, at any time, request that the provision of services other than basic local exchange services be deregulated. The commission shall order deregulation upon a showing that functionally equivalent or substitute services are available at competitive rates, terms, and conditions. [46-5-170(b)].

The telecommunications company electing alternative regulation under this article may request that any form of regulation of basic local exchange services be terminated and that such services be provided on a deregulated basis. The commission shall order such deregulation in any geographic area where 30 percent of the residential households or single-line businesses have a functionally equivalent or substitute service available at competitive rates, terms, and conditions for basic local exchange services. [46-5-170(c)].

Senate Bill 566 was not enacted, but on June 22, 1994, Southern Bell filed its "Georgians FIRST" proposal with the Commission to succeed the incentive plan approved by the Commission three years earlier on Docket 3905-U and due to expire on June 30, 1994. That plan resembles S.B. 566 in most respects except that the freeze on basic services would last for five years, and there is no cap on interconnection service rates. It contains the identical provision that on the effective date of the plan, all existing rates, terms and conditions for the services in Southern Bell's existing tariffs and contracts would be deemed just and reasonable.

Effect

During the course of the audit the auditors noted several specifically identifiable and assignable costs associated with existing services (e.g. ESSX, ONA, ISDN, etc.) which are currently regulated but would have been placed in the "all other services" category under S.B. 566. The auditors also noted costs associated with new and future services (e.g., Video-On-Demand and other broadband services) that were charged to regulated operations. Although these costs were properly treated as regulated under the terms of the Company's existing CAM, under S.B. 566 they would either be nonregulated or directly assignable to the "all other services" category whose prices would be set solely by the

company.⁵⁹

This finding is significant. Under the terms of S.B. 566, the Company would have the unrestricted ability to set the prices for its enhanced, competitive, and new services. At the same time it would be assured of indexed price increases from its monopoly POTS service. Under S.B. 566, all existing rates would be deemed just and reasonable upon the date the Company files its notice of intent to adopt alternative regulation. There would be no further surveillance reporting or any other type of earnings scrutiny.⁶⁰

Cause

An embedded base of captive customers for a service which has become a basic necessity, combined with the service and revenue potential produced by advanced technology and potential competition for existing and future services, provides an incentive to absorb the costs related to competitive and future services with revenues derived from captive customers.

Recommendation

S.B. 566 demonstrates the Company's desire to change the existing regulatory environment to a more permissive environment. The auditors recommend that the Commission accelerate its

⁵⁹S.B. 566, sections 46-5-169 and 46-5-170(a). On August 14, 1992 the FCC released Order FCC 92-327 in CC Docket No. 87-266 which authorizes telephone company provision of Video Dialtone as an interstate service (para. 72). It would appear, therefore, that Video Dialtone costs should be assigned to interstate.

⁶⁰S.B. 566, section 46-5-165(c).

examination of the other findings of this audit and treat their resolution with considerable urgency. Otherwise, the opportunity to eliminate subsidies now embedded in the Company's rates may be lost owing to changes in the framework under which the Commission regulates Southern Bell.

15. The Company's regulated vs. nonregulated cost allocation process should be subjected to continued and increased audit scrutiny.

Summary

A review of the cost allocation assignment process for the audit period 1988 through 1991 verified that the costs associated with the nonregulated CDAR and Public Telephone Voice Message ("PTVM") Services in Georgia were assigned to the nonregulated service category, while the nonregulated revenue was assigned to regulated services.⁶¹ Southern Bell - Georgia's customers were not harmed by the cost and revenue assignment process for these services, but to a limited extent actually benefitted from the assignment of some minor nonregulated revenue to regulated operations. No additional action is required at this time for these services. However, continued and increased audit scrutiny of the regulated vs. nonregulated cost allocation process will become much more critical as the Company's nonregulated operations increase. As the number of nonregulated services increase there are greater possibilities of revenue to cost mismatches and there is a greater need to insure that the costs of the remaining regulated services are accurate based upon usage or whatever other measurement tools are used.

⁶¹PTVM was never offered in Georgia but a small amount of overheads was mechanically assigned to nonregulated for PTVM prior to October, 1993. This provided a small benefit to regulated operations.

Criteria/Condition

The objective of this audit activity was to verify that the costs associated with the provision of non-regulated services are being assigned to the nonregulated segment of the business. To accomplish this verification, the cost and revenue data information contained on the Company's NONREG Product Income Statement (Report 1648) was evaluated by product and compared with the assignment in the CAM data for Georgia which assigns expenses, revenue and investment by cost pools.

Effect

A review of the cost allocation assignment process verified that the cost associated with nonregulated services were being assigned to the nonregulated category, while the nonregulated revenue was being assigned to regulated services. The effect of the cost and revenue assignment process for these services is that Southern Bell of Georgia's customers are not being harmed, but to a minor extent actually benefit from the assignment of some minor nonregulated revenue to regulated operations.

Cause

The Company representatives interviewed indicated that the revenue associated with CDAR for the audit period was at such a low level that the benefits to the Company did not justify the additional cost required to separate the revenue into the nonregulated category.

Recommendation

No additional action is required at this time for these services. Continued and increased audit scrutiny of the Company's regulated vs. nonregulated cost allocation process is warranted, however, as nonregulated operations and services increase.

16. The auditors recommend the use of positive time reporting for BellSouth's and Southern Bell's legal departments.
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Summary

The objective of this audit activity was to verify that BellSouth's and Southern Bell's Legal Department expenses are being properly assigned to regulated and nonregulated services. The auditors determined that no internal or external audit was performed for any Legal Department employee during the audit period. The availability of such an audit may have resolved some of the uncertainty in verifying past work activities of the Legal Departments.

The allocation of Legal Department employee time and related expense is based on exception time reporting and the pre-assignment of job function codes ("JFCs"). These procedures result in an inability to verify the propriety of the allocation of Legal Department costs.

The inability to verify conclusively whether there has been a correct allocation of Legal Department employee time to nonregulated activities was demonstrated by the auditors' review of the 1991 time allocation of two of the Company's attorneys. One of the attorney's formal filing activity related almost exclusively to nonregulated services such as Cellular, Personal Communication Services and Radio Experimental Applications, yet only 12 percent of his time was assigned to the nonregulated cost category. The auditors acknowledge that this attorney could have worked on other functions, but with exception time reporting there is no record of

those activities.

After the fact, it is virtually impossible to verify if the personnel in the legal department have accurately reported their time relating to nonregulated activities, because, unless exception time has been reported, the Company does not have any detailed records of what functions were being performed at any given time.

The auditors recommend that BellSouth's and Southern Bell's Legal Departments be required to change to positive time reporting. The auditors also recommend that the cost pools to which Legal Department time is assignable include nonregulated, interstate and intrastate by state jurisdiction, or seek modification of the Part 69 rules.

Criteria

One of the objectives of this audit was to learn whether Southern Bell's regulated customers are protected from cross-subsidy. The Georgia PSC has defined cross-subsidy as any action undertaken by SBT which results in an understatement of intrastate regulated revenues or an overstatement of intrastate regulated expenses or investment for SBT.

Condition

Below is a listing of the sources of the \$4,458,694 legal expense (Account 6725) reported on Georgia's 43-03, 1991 ARMIS Report:

Georgia Legal Dept.	\$ 1,284,027	28.8%
Southern Bell Legal	1,587,591	35.6%
BellSouth Headquarters	<u>1,587,006</u>	<u>35.6%</u>
	\$ 4,458,694	100.0%

A review of the formal Docket information provided by the Company was conducted and compared to the eventual assignment of BellSouth Headquarters' legal expense. A major portion of the activities reviewed involved FCC filings and dockets which do not relate to the provision of intrastate customer service. BellSouth's legal expense is first allocated to Southern Bell and then apportioned to Georgia operations.

The allocation of BellSouth and Southern Bell Legal Department employee time and related expense is based on exception time reporting and the pre-assignment of job function codes. During the audit period, the Legal Department had 22 six digit JFCs, ten of which were assigned to nonregulated activities. The JFC Mini File directs the predominance of cost assignment and the use of exception reporting generally applies only to special activities. A work function profile is established for each individual and only when the individual reports exception time is a record produced indicating specific work activities. If no exception time is reported, then the individual's time is allocated based on the preassigned profile.

The auditors requested copies of all external and internal audits which included the Legal Department, so that the results could be analyzed. Initially the Company provided a copy of an November 15, 1991 audit report for the Part 64 - Job Function Code

audit prepared by the internal auditors. Investigation revealed that no personnel in the Legal Department were actually evaluated. The Company's responses to numerous other audit data requests indicate that the Company's internal auditors have not conducted a formal audit of the Southern Bell's Legal Departments since at least 1988. The Company indicates that its internal review procedures for evaluating JFC assignments is the direct responsibility of it's "segment accounting coordinators" who do not issue any formal reports summarizing their findings.

The assignment of an employee's JFCs generally takes place only when an employee changes jobs or when there is a general reorganization. The Company's response to data request JWC-58 (Supplement) indicates that a questionnaire is sent quarterly to a random sample of employees, but the data responses indicate that the Legal Departments have not received such a questionnaire. The Company's responses to JWC-46, JWC-57 & JWC-58 indicate that no formal report summarizing the results of these surveys has been issued.

The auditors had several meetings with Company personnel seeking alternative sources for information which could be verified for the audit period. These meetings identified the JFC Quality Task Force which had been recently established as a possible source for auditable information relating to the Legal Department. The Company's subsequent response to data requests indicated that the Task Force's first review of the Legal Department occurred on June 15, 1992. The Company response to the auditors' information

request stated that a formal report was not issued by the task force and that "The JFC Quality Task Force Team was formed primarily to reduce the number of JFCs and to simplify the associated assignment and administrative process." The Company also stated that the material associated with the Task Force's work effort is "clearly outside the 1988 - 1991 audit period" but that the simplification process reduced the number of job function codes by 45 percent.

The Company's responses to the auditors' data requests and interviews relating to the Legal Department's reported time, indicates that there is no documentation for the audit period which would provide verification that the actual time reported corresponds to the exception time reporting rules. The departmental budget process tracks expenses by general functions (e.g. training, personnel, travel expenses, relocation expenses), but it does not attempt to track expenses by services or activity for potential regulatory assignment.

For example, if an employee's Mini File indicates 12 percent of his time is assigned to nonregulated function codes, then that is the time that would be assigned unless the employee maintained separate personal records of what his actual assignments were. These personal records would need to identify each assignment, whether the assignment was regulated or nonregulated, the hours spent, and the cumulative nonregulated hours versus total hours. With this type of personal record, the employee might be able to estimate the portion of his time that is exception time. However

it is unlikely that anyone would maintain such records unless they were required to do so.

The Legal Department's work functions are not repetitive in nature, as are those of the Company's plant departments. If the work functions were repetitive and consistent, a survey could provide a verifiable indication as to whether the department's time is being properly assigned. But this is not the case where an individual may work on one activity one day and never address the issue again.

In response to data requests, the Company provided the auditors with a list of 1991 Company formal legal filings. The list identified which of its attorneys was responsible for each filing. The Company also provided information relating to each of those attorneys' time allocation between regulated and nonregulated cost pools. The auditors selected information on attorneys Helen Shockey and R. Frost Branon for evaluation. Ms. Shockey and Mr. Branon were BellSouth attorneys.

The data provided by the Company indicated that 100 percent of Ms. Shockey's but only 88 percent of Mr. Branon's 1991 time was assigned to regulated activities. The auditors' review of the filings list indicates that all of Ms. Shockey's activities seem to pertain to regulated activities. Therefore, the 100 percent assignment of her time appears to be correct. The auditors' review of Mr. Branon's time and filing data does not result in the same conclusion. Below is a complete list of filings for which Mr. Branon was responsible:

<u>FILING</u> <u>DATE</u>	<u>DOCKET #</u>	<u>DOCKET DESCRIPTION/SUBJECT</u>
1-15-91	90-314	Personal Communications Services
3-11-91	RM-7618	PCS - Data (Apple Corp. PFRM Comments)
4-12-91	89-554	ITU WARC Frequency Allocations
5-20-91	91-33	Cellular Resale Policies
5-20-91	91-34	Cellular Bundling
7-24-91	90-314	Personal Communication Services Field Trials Results
8-15-91		Radio Experimental Application

The Company's explanation of Mr. Branon's charges to regulation indicates that since the PCS FCC Docket was in the early stages of inquiry and development, and it was uncertain whether it would be considered a regulated or nonregulated business, it was appropriate to charge PCS cost to regulation. The Company also indicated that since the original FCC Cellular ruling was built around a telco bundling decision it was necessary to review and compare the bundling applications to determine if such a decision applied to Cellular. Therefore, once again the cost was assigned to the regulatory cost pool, rather than nonregulated services.

The Company explained that in 1991, BellSouth followed and/or intervened in twenty-seven cases arising from proceedings at the FCC and from the MFJ, and that nearly two-thirds of these cases were related to telephone company matters. Mr. Branon was apparently responsible for BellSouth's efforts in those cases as well as the cases he handled in the regulatory area. In other words, at least one third of the other cases did not relate to telephone company matters and the other two-thirds did not relate to regulatory matters. Nevertheless, only 12 percent of Mr.

Branon's time was charged to nonregulated. Conversely, 88 percent of Mr. Branon's time was charged to regulated, even though a majority of his work appears to have related to nonregulated matters.

The problem is that with exception time reporting, it is virtually impossible to verify after the fact whether the personnel in Southern Bell's legal department have accurately reported their exception time relating to nonregulated activities. Unless exception time has been reported, the Company does not have detailed records of what functions were being performed at any given time.

The problem for Georgia and Southern Bell is not simply the assignment of cost between regulated and nonregulated activities. There is a more critical issue involving BellSouth Headquarters' Legal Department. BellSouth Headquarters' Legal Department is involved in the establishment and operation of numerous nonregulated companies and other nonregulated business activities. In general, the assignment of its legal expense is based on a fully distributed cost concept for allocation. Under this process, BellSouth's legal cost is allocated to its subsidiaries based on either their legal expenses or type of work performed. Since the telephone operations have more attorneys than any of the other BellSouth enterprise companies, a majority of the legal expense is allocated to telephone operations where the general allocator is used.

The allocated expense is further reallocated to each state

jurisdiction by Southern Bell and South Central Bell. Ultimately after all of the allocations have been completed, the majority of the expense is assigned to intrastate regulation. The use of general allocators for cost assignment invariably results in a major portion of the legal expense being assigned to intrastate, when in fact the activities which caused the expense to occur are primarily either nonregulated services or interstate filings and has little or nothing to do with intrastate regulation or services. Therefore, the cost allocation problems associated with legal expense stem not only from the use of exception time reporting, but also from a lack of cost pools sufficient to assure that costs are driven to the appropriate categories.

Effect

Inability to determine if Legal Department time is appropriately charged.

Cause

Exception time reporting.

Recommendation

The auditors recommend that the Company eliminate the use of exception time reporting and require positive time reporting for all employees in the BellSouth and Southern Bell Legal Departments. This will assure that each individual is held more directly accountable for how his or her time is charged, as the individual's

time report would require their signature. Positive time reporting may reduce any predisposition of the Company to automatically charge regulated services for its legal costs. The need for this change will become more critical as the Company moves into additional nonregulated areas of service.

17. Chaining calculations relating to affiliated transactions should recognize operations, such as BAPCO, which are treated as regulated at the intrastate level.

SUMMARY

BellSouth Enterprises, Inc. ("BSE") leased space in a building located at 1100 Peachtree Street from Sunlink (an affiliate) at a price per square foot which is significantly greater (\$393,349 annually) than the amount being paid by other non-affiliated tenants in the building.⁶² A portion of this excess flowed directly into regulated operations. A greater portion flowed indirectly into Georgia's regulated intrastate operations since BAPCO's net income is treated as regulated for Surveillance Report purposes.⁶³

Southern Bell should be required to calculate all affiliate costs "chaining" into intrastate regulation, and not restrict its chaining calculation to the FCC's interstate definition of what is regulated and nonregulated. This calculation should recognize that BAPCO is treated as a regulated entity. The auditors also recommend that the Commission continue to impose strict monitoring of all affiliated leases in which any portion of the lease cost is included in intrastate revenue requirements, expenses or earnings.

⁶²\$393,349 annually on a going-forward basis.

⁶³The annual amount flowing to Georgia is estimated to be approximately \$12,000. No adjustment is proposed for this minor amount.

Criteria

The auditors analyzed the lease information contained in the Coopers & Lybrand's ("C&L") 1991 Part 64 audit workpapers as well as the Company's affiliate billings to evaluate the impact on Southern Bell's net income adjustments. BSE's intercompany billing practices were analyzed to determine if BSE's 2.1 percent management fee billing method protects the regulated customers from the excessive rent paid by BSE for the 1100 Peachtree property. Since the accounting structures of BSE's foreign and start-up companies are not comparable to those of BSE's established U.S. companies, a review of C&L's Part 64 evaluation was conducted to determine the potential impact of the excessive lease's cost on Georgia's BAPCO net income adjustment.

Condition

BSE's lease for 1100 Peachtree is a "market priced" lease. The data included in the C&L's 1991 Part 64 audit workpapers (Binder 37) relating to the lease indicates that BSE's lease payments are \$636,469 per year greater than a comparable Kilpatrick & Cody lease in the same building. The Company has subsequently furnished the auditors with information which indicates that the 1991 lease data included in C&L's workpapers was not complete, and that lease concessions were made to BSE in 1992 and 1993, that reduced the excessive amount per year from \$636,469 to \$393,349. Since these concessions took place outside the specified (1988 - 1991) audit period, the revised lease documents or C&L's 1992 and 1993 work

papers have not been reviewed by the auditors.

As part of its 1991 Part 64 Attestation audit, C&L performed a chaining evaluation which determined that 2.4 percent of the excess lease expense would flow to regulation. However, since C&L's chaining calculation was based on the FCC's definition of regulated and nonregulated, it did not recognize that more than 2.4 percent would flow into Georgia's regulated operations due to its treatment of BAPCO's net income.

Effect

BSE incurred an excessive lease payment. The annual amount of the excessive lease payment to Sunlink was \$393,349. This payment is not significant from an interstate perspective, because all of BSE's Companies were nonregulated from the FCC's perspective, with only a small portion of those costs chaining into interstate regulated operations. A greater portion of the excess flowed into the regulated operations in Georgia since BAPCO is treated as regulated in Georgia.

Cause

C&L's chaining impact evaluation was based on the FCC's definition of regulated and nonregulated companies. This evaluation did not recognize that BAPCO is treated as a regulated company in Georgia.

Recommendation

The auditors recommend that for intrastate reporting purposes, Southern Bell should be required to calculate all affiliate BellSouth Corporation costs "chaining" into intrastate regulation as defined by Georgia's Surveillance Report, and not just the FCC's definition of what is regulated and nonregulated. The auditors also recommend that the Commission reaffirm its need to have access to the BellSouth's nonregulated affiliates' books and records to ensure that any costs flowing into regulation are not excessive or that a cross-subsidy is not taking place.